

# ANSWERS TO QUESTIONS

1. The following steps are frequently involved in management's decision-making process:
  - (a) Identify the problem and assign responsibility.
  - (b) Determine and evaluate possible courses of action.
  - (c) Make a decision.
  - (d) Review results of the decision.
2. Your roommate is incorrect. Accounting contributes to the decision-making process at only two points: (1) prior to the decision, accounting provides relevant revenue and cost data for each course of action, and (2) following the decision, internal reports are prepared to show the actual effect of the decision on net income.
3. Disagree. Incremental analysis involves the identification of financial data that change under alternative courses of action.
4. In incremental analysis, the important point to consider is whether costs will differ (change) between the two alternatives. As a result, (1) variable costs may change under the alternative courses of action and (2) fixed costs may not change.
5. The relevant data in deciding whether to accept an order at a special price are the incremental revenues to be obtained compared to the incremental costs of filling the special order.
6. The manufacturing costs that are relevant in the make-or-buy decision are those that will change if the parts are purchased.
7. Opportunity cost may be defined as the potential benefit that may be obtained by following an alternative course of action. Opportunity cost is relevant in a make-or-buy decision when the facilities used to make the part can be used to generate additional income.
8. The decision rule in a decision to sell a product or to process it further is: Process further as long as the incremental revenue from the additional processing exceeds the incremental processing costs.
9. A sunk cost is a cost that cannot be changed by any present or future decision. Sunk costs, therefore, are not relevant in a decision to retain or replace equipment.
10. Net income will be lower if an unprofitable product line is eliminated when the product line is producing a positive contribution margin and its fixed costs cannot be avoided or reduced.
11. Contribution margin per unit of limited resource is determined by dividing the contribution margin per unit of the product by the number of units of the limited resource required to produce one unit of the product.
12. The screening of proposed capital expenditures may be done by a capital budgeting committee which submits its findings to the officers of the company. The officers, in turn, select the projects they believe to be the most worthy of funding and submit them to the board of directors. The directors ultimately approve the capital expenditure budget for the year.

## Questions Chapter 26 (Continued)

13. The formula for the annual rate of return technique is: Annual net income  $\div$  average investment.
14. Cost of capital is the rate of return that management expects to pay on all borrowed and equity funds. The decision rule is: A project is acceptable if its rate of return is greater than or equal to management's minimum rate of return (which often is its cost of capital), and the project is unacceptable when the rate of return is less than the minimum rate of return.
15. Hank is not correct. The formula for the cash payback technique is: Cost of the capital investment  $\div$  net annual cash flows. The formula for the annual rate of return is: Expected annual net income  $\div$  average investment.
16. The cash payback technique is relatively easy to compute and understand. However, it should not ordinarily be the only basis for the capital budgeting decision because it ignores the profitability of the investment and the time value of money.
17. The two tables are:  
(1) Table 1 is the present value of a single future amount. This table is used when a project has uneven cash flows over its useful life.  
(2) Table 2 is the present value of a series of future cash flows. This table is used when a project has equal cash flows occurring at equal intervals of time over its useful life.
18. The decision rule is: Accept the project when net present value is zero or positive; reject the project when net present value is negative.
19. The steps are:  
(a) Compute the rate of return factor by dividing Capital Investment by Net Annual Cash Flows.  
(b) Use the factor and the present value of an annuity of 1 table to find the internal rate of return.
20. Under the internal rate of return method, the objective is to find the rate that will make the present value of the expected annual cash inflows equal the present value of the proposed capital expenditure. The decision rule under the internal rate of return method is: Accept the project when the internal rate of return is equal to or greater than the required rate of return, and reject the project when the internal rate of return is less than the required rate.